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Economic reforms: How to tax tobacco under GST regime

GST must be levied on all unmanufactured tobacco at the standard rates with input tax credit

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The passage of the GST Bill by Parliament represents the start of a new phase of economic reforms in the country which will have far-reaching impact. (Reuters)

The passage of the GST Bill by Parliament represents the start of a new phase of economic reforms in the country which will have far-reaching impact. With the politics of getting the legislative hurdles out of the way, the challenges of implementation of GST are now before us. As the Centre and states converge on the details, they have shown a seriousness of purpose and intent which is most welcome. The ambitious timelines for roll-out of this major tax reform by the prime minister now appear to be achievable as the details get worked upon in a harmonious manner.

Given the above, the primary objective of a genuine pan-India common market is becoming increasingly viable. The secondary benefits of better “capture” of all transactions, i.e., goods and

services, will also happen, resulting in a substantial part of the 'informal' economy shifting to the 'formal', thereby positively impacting India's GDP profile.

GST has been attempted in several geographies, albeit with mixed results. Similar benefits will undoubtedly accrue in India over the next 2-3 years as the GST framework gets fully established. The outcomes can, however, be significantly 'amplified', if the categories hitherto exempted from the tax-net or taxed in a distorted manner, are revisited simultaneously. This will also help provide a cushion for any shortfall in revenues in the initial years.

Estimate of evaded tobacco taxes

(₹ crore)

	Cigarettes	Bidi	Other Tobacco	Total
Consumer Spend (CS)	60,874	22,420	60,959	1,44,253
Tax evaded @ 48%	7,816	10,537	51,345	69,698
Taxed CS	53,058	11,883	9,614	74,555
Additional revenue potential if all tobacco is taxed				
Current excise (#)	7,956	405	13,776	22,137
VAT	1,352	1,317	7,426	10,095
Total tax evaded	9,308	1,722	21,202	32,232

#Includes escaped Customs Duty on suggested cigarettes

An obvious example of such a sector is tobacco, the use of which is universally accepted as being harmful, and in the Indian context, a major health concern with particular reference to the habit of chewing tobacco. Almost 560 million kilos of tobacco is consumed in India annually, of which 68% in quantity and 48% in value terms is currently untaxed. Cigarettes which account for just 11% of tobacco consumption account for 87% of tobacco tax revenues. Bidi, on the other hand, is exempted from VAT in nine states and taxed at a low value in 13 others. The situation is even more skewed in respect of chewing tobacco (khaini, gutkha, etc) where almost 90% evades the tax net altogether, notwithstanding the fact that it is relatively the more serious health hazard in comparison with bidi and cigarettes, in that order. Even within these three segments, attractive tax arbitrage exists, particularly so in respect of cigarettes due to high and differential rates of VAT. The additional revenue potential if the entire value of tobacco is brought under the tax net is estimated at over R30,000 crore.

Cigarette-centric tobacco taxation has become a double jeopardy by undermining both health as well as revenue objectives.

While tobacco consumption increased by 38% from 406 million kg (1981-82) to 562 million kg in 2014-15, the consumption of cigarettes declined from 21% to 11% during the corresponding period. The loss of revenue is primarily due to fragmented manufacturing in the unorganised sector and rampant tax evasion. The cigarette-centric tax policies continue to expose the consumers, particularly at the lower socio-economic strata to substandard and unhygienic tobacco products. At the current tax ratio, the effective incidence of tax per kilo of tobacco used in cigarettes is over 50 times more than the tax on other tobacco products. This huge tax gap disincentivises the consumer from consumption of legal, duty-paid and relatively less harmful cigarettes and encourages her to shift to more harmful and tax-inefficient tobacco products like khaini, bidi, gutkha, etc. This skewed tax structure has in fact led to an increase in the share of other tobacco products, from 79% in 1981-82 to 89% in 2014-15.

The incidence of tax on cigarettes with reference to per-capita GDP is also much higher in India relative to other major markets like the US, China, Australia, etc. Thus, it is no surprise that India is today the fourth-largest market for illicit cigarettes, with FICCI estimating the annual loss of revenue at over R9,000 crore.

GST will be a real game changer if it can factor in the need to remove the distortion and infirmities of the current tobacco taxation policy. An equitable taxation structuring on tobacco will not only ensure sustainable revenue buoyancy but also, more important, address the bigger concern of rampant use of chewing tobacco which is a major health concern in the country.

The way forward is levy of GST on all unmanufactured tobacco at the standard rates with input tax credit at every stage of value addition. The Centre can levy excise duty on all tobacco products as currently being done. This will discourage under-valuation and keep it litigation-free. Similar to tobacco, there are several other verticals where there is an urgent need for tax rationalisation and reforms.

For too long have we allowed populist policies to determine our tax paradigm. The full benefit of GST will accrue only when the tax structures are determined on a scientific and principled understanding based on empirical evidence and by adopting global experience and best practices.

A good beginning can be made with the taxation strategy as outlined above on all tobacco products with the primary objective being better public health on which bipartisan support of all political parties is possible.

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